

**Internal Revenue Service**

Appeals Office  
2525 Capitol Street, Suite 201, MS 55204  
Fresno, CA 93721

Release Number: **201237020**

Release Date: 9/14/2012

Date: June 21.2012

A

B

**Department of the Treasury**

Taxpayer Identification Number:

C

Person to Contact:

Employee ID Number:

150362

Tel:

Fax:

Tax Period(s) Ended:

D

UIL: 501.03-22

**Certified Mail**

Dear ,

This is a final adverse determination regarding your exempt status under section 501(c)(3) of the Internal Revenue Code (the "Code"). It is determined that you do not qualify as exempt from Federal income tax under section 501(c)(3) of the Code effective January 1, 2004.

The revocation of your exempt status was made for the following reason(s):

Your primary activity consists of conducting weekly bingo games and the sale of pull-tabs. Conducting bingo games and the selling of pull-tabs are not activities which further charitable or educational purposes within the meaning of Internal Revenue Code section 501(c)(3). In addition, we found that you have a program of making contributions to charitable and educational organizations. Your organization's program of charitable giving, while laudable, is insubstantial and incidental in comparison to your primary activity. To be exempt, an organization's primary activity must further purposes described in section 501(c)(3). Since your primary activity does not further exempt purposes you have not operated exclusively for exempt purposes as is required for continuing recognition of you by the Internal Revenue Service as an organization described in section 501(c)(3).

Contributions to your organization are not deductible under section 170 of the Code.

You are required to file Federal income tax returns on Forms 1120 for the tax periods stated in the heading of this letter and for all tax years thereafter. File your return with the appropriate Internal Revenue Service Center per the instructions of the return. For further instructions, forms, and information please visit [www.irs.gov](http://www.irs.gov).

If you were a private foundation as of the effective date of revocation, you are considered to be taxable private foundation until you terminate your private foundation status under section 507 of the Code. In addition to your income tax return, you must also continue to file Form 990-PF by the 15th Day of the fifth month after the end of your annual accounting period.

Processing of income tax returns and assessments of any taxes due will not be delayed should a petition for declaratory judgment be filed under section 7428 of the Code.

If you decide to contest this determination, you may file an action for declaratory judgment under the provisions of section 7428 of the Code in one of the following three venues: 1) United States Tax Court, 2) the United States Court of Federal Claims, or 3) the United States District Court for the District of Columbia. A petition or complaint in one of these three courts must be filed within 90 days from the date this determination letter was mailed to you. Please contact the clerk of the appropriate court for rules for

filing petitions for declaratory judgment. To secure a petition form from the United States Tax Court, write to the United States Tax Court, 400 Second Street, N.W., Washington, D.C. 20217. See also Publication 892.

You also have the right to contact the office of the Taxpayer Advocate. Taxpayer Advocate assistance is not a substitute for established IRS procedures, such as the formal appeals process. The Taxpayer Advocate cannot reverse a legally correct tax determination, or extend the time fixed by law that you have to file a petition in a United States Court. The Taxpayer Advocate can however, see that a tax matters that may not have been resolved through normal channels get prompt and proper handling. If you want Taxpayer Advocate assistance, please contact the Taxpayer Advocate for the IRS office that issued this letter. You may call toll-free, 1-877-777-4778, for the Taxpayer Advocate or visit [www.irs.gov/advocate](http://www.irs.gov/advocate) for more information.

If you have any questions, please contact the person whose name and telephone number are shown in the heading of this letter.

Sincerely Yours,

Appeals Team Manager  
Karen A. Skinder

Enclosure: Publication 892



DEPARTMENT OF THE TREASURY

INTERNAL REVENUE SERVICE

TE/GE EO Examinations

4330 Watt Ave SA6209 EO

Sacramento, CA 95821

TAX EXEMPT AND  
GOVERNMENT ENTITIES  
DIVISION

ORG  
ADDRESS

Date

Taxpayer Identification Number:

Form:

Tax Year(s) Ended

Person to Contact/ID Number:

Contact Numbers:

Telephone:

Fax:

CERTIFIED MAIL – RETURN RECEIPT REQUESTED

Dear

We have enclosed a copy of our report of examination explaining why we believe revocation of your exempt status under section 501(c)(3) of the Internal Revenue Code is necessary.

If you accept our findings, please sign and return the enclosed Form 6018, Consent to Proposed Action - Section 7428. If you have already given us a signed Form 6018, you need not repeat this process. We will issue a final revocation letter.

If you do not agree with our proposed revocation, you must submit to us a written request for Appeals Office consideration within 30 days from the date of this letter to protest our decision. Your protest should include a statement of the facts, the applicable law, and arguments in support of your position.

An Appeals Officer will review your case. The Appeals Office is independent of the Director, EO Examinations. The Appeals Office resolves most disputes informally and promptly. The enclosed Publication 3498, The Examination Process, and Publication 892, Exempt Organization Appeal Procedures for Unagreed Issues, explain how to appeal an Internal Revenue Service (IRS) decision. Publication 3498 also includes information on your rights as a taxpayer and the IRS collection process.

You may also request that we refer this matter for technical advice as explained in Publication 892. If we issue a determination letter to you based on technical advice, no further administrative appeal is available to you within the IRS regarding the issue that was the subject of the technical advice.

If we do not hear from you within 30 days from the date of this letter, we will process your case based on the recommendations shown in the report of examination. If you do not protest this proposed determination within 30 days from the date of this letter, the IRS will consider it to be a failure to exhaust your available administrative remedies. Section 7428(b)(2) of the Code provides, in part: "A declaratory judgment or decree under this section shall not be issued in any proceeding unless the Tax Court, the Claims Court, or the District Court of the United States for the District of Columbia determines that the organization involved has exhausted its administrative remedies within the Internal Revenue Service." We will then issue a final revocation letter.

You have the right to contact the office of the Taxpayer Advocate. Taxpayer Advocate assistance is not a substitute for established IRS procedures, such as the formal appeals process. The Taxpayer Advocate cannot reverse a legally correct tax determination, or extend the time fixed by law that you have to file a petition in a United States Court. The Taxpayer Advocate can, however, see that a tax matter that may not have been resolved through normal channels gets prompt and proper handling. You may call toll-free 1-877-777-4778 and ask for Taxpayer Advocate Assistance. If you prefer, you may contact your local Taxpayer Advocate at:

If you have any questions, please call the contact person at the telephone number shown in the heading of this letter. If you write, please provide a telephone number and the most convenient time to call if we need to contact you.

Thank you for your cooperation.

Sincerely,

Sunita Lough  
Director, EO Examinations

Enclosures:  
Publication 892  
Publication 3498  
Report of Examination  
Form 6018

Form <b>886A</b>	Department of the Treasury - Internal Revenue Service	Schedule No. or Exhibit
<b>Explanation of Items</b>		
Name of Taxpayer ORG EIN	TIN	Year/Period Ended 20XX12 & 20XX

**LEGEND**

ORG - Organization name XX - Date Address - address City - city  
 State - state BM-1 - 1<sup>st</sup> BM CO-1 & CO-2 - 1<sup>st</sup> & 2<sup>nd</sup> COMPANIES Motto  
 - motto

**Issue:**

Whether the tax-exempt status of an organization, whose only activity is conducting motto games while making only insubstantial donations to charity, should be revoked.

**Facts:**

ORG Scholarship (ORG) is recognized as a tax-exempt organization under IRC 501(c)(3) in May 20XX. The organization was incorporated in the state of State in March 20XX. According to its articles of incorporation, the stated purpose of this corporation is to promote and support educational opportunities for children and young adults in the United States of America. The only activity that the organization participated in was an on going motto game. The organization does not have a phone number other than that of the officer's home number. The address listed by the organization on their Form 990 is that of one of the officers of the organization.

The organization conducts weekly motto events in an effort to raise funds for their stated purpose of supporting education opportunities for children. The games are held on Sunday afternoon starting at 1:45PM, Sunday evening starting at 7:00 PM, and Monday starting at 7:00PM. The sessions were held at Address, City, State. In 20XX sessions were also held at the Address location. The events are open to the general public and ORG estimates that anywhere from 120 to 300 people may attend a motto event. Three types of motto are generally conducted which are session motto, electronic motto, and pull-tabs (called flash games by ORG). Session motto is basically traditional motto where a number is called and players mark the number on their corresponding cards, electronic motto is played with electronic handsets, and pull-tabs are tickets purchased that give a player a chance to win instant cash. No other revenue generating activities are conducted by ORG.

Total gross receipts for the years 20XX through 20XX were \$, \$, and \$ respectively. ORG made charitable donations from 20XX through 20XX. In 20XX the organization donated \$ to charity. In 20XX the org donated \$ to charity. In 20XX distributions of \$ were made. For the years 20XX thru 20XX the organization had \$ in revenue while donating \$ to charity, this is a percentage of % over a three year period.

Year	Gross Receipts	Donated to Charity	Percentage
20XX			
20XX			



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20XX			
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ORG states that it cannot make greater charitable distributions because it has not been very profitable in the years 20XX thru 20XX. The majority of the organization's revenue is paid out to winners of motto games. From looking at ORG's profit and loss statements it can be determined that in 20XX roughly % of gross receipts was paid out to winners of motto games, % was paid as rental of facilities and motto equipment, 2% was paid to charity. In 20XX roughly % of gross receipts was paid out to winners of motto games, % was paid as rental of facilities % was donated to charity. In 20XX roughly % of gross receipts was paid out to winners of motto games, % was paid for rental of facilities and motto equipment, 0.6% was paid to charity. ORG leases the motto hall from CO-1 . for a total of over \$ for every session. ORG leases motto equipment from CO-2 based on a percent of the session's net profits, as well as a flat rate for the rental of handsets. Payments to CO-2 are typically over \$ for each session. It should be noted that BM-1 is the person who signed as the lessor on both the contract between ORG and CO-1. and between ORG and CO-2 Facility rents paid were as follows, in 20XX - \$ or \$ per month. In 20XX - \$ or \$ per month ( there were two locations in 20XX, Address \$ & Address \$). In 20XX the org paid \$ or \$ per month. Equipment Rental (these amounts were paid to CO-2 a company controlled by BM-1) was \$ (or \$ per month) in 20XX, \$ (or \$ per month) in 20XX and \$ (or \$ per month) in 20XX. It should be noted that during this time period State state law limited rent and overhead to \$ per month.

Year	Facility Rental/Month	Equipment Rental/Month
20XX		
20XX		
20XX		

The organization utilized the services of private security guards at the motto games, these individuals were treated as private contractors. For the 20XX year they were paid \$, they were paid \$ in 20XX while in 20XX they were paid \$. Their services were described as providing protection for the motto operation. They were paid by check at the end of each motto session. The organization states that the guards had no direct involvement with the operations of the games. Their duties were described as monitoring doors inside and outside hall, maintaining noise levels and disruptions and player safety. It should be noted that for the years 20XX thru 20XX that compensation payments for security exceeded donations to charity.

**Law:**

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### Charitable Contributions :

Section 501(c)(3) of the Internal Revenue Code exempts from federal income tax organizations organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, educational purposes, to foster national or international amateur sports competition, or for the prevention of cruelty to children or animals, provided that no part of the organization's net earnings inures to the benefit of any private shareholder or individual.

Section 1.501(c)(3)-1(a)(1) of the regulations provides that in order to be exempt as an organization described in section 501(c)(3) of the Code, the organization must be one that is both organized and operated exclusively for one or more of the purposes specified in that section.

Section 1.501(c)(3)-1(c)(1) of the regulations provides that an organization will not be regarded as operated exclusively for exempt purposes if more than an insubstantial part of its activities is not in furtherance of exempt purposes.

Section 1.501(c)(3)-(d)(1)(ii) of the regulations provides that an organization is not organized or operated exclusively for one or more of the purposes specified in subdivision (i) of this subparagraph unless it serves a public rather than a private interest. Thus, to meet the requirement of this subdivision, it is necessary for an organization to establish that it is not organized or operated for the benefit of private interests such as designated individuals.

In Rev. Rul. 64-182, 1964-1 C.B. 186, the IRS ruled that an organization qualified for exemption under IRC section 501(c)(3) where it used proceeds from a business activity to conduct a charitable program, commensurate in scope with its financial resources, of making grants to other charitable organizations.

In *Help the Children, Inc. vs. Commissioner*, 28 T.C. 1128 (1957), a section 501(c)(3) organization conducted motto games as its principle activity. Its stated purpose was to promote lawful forms of entertainment and amusement to acquire funds and financial assistance for the care and assistance of needy children and children's institutions. Its charitable function consisted of contributions to charitable institutions of amounts that were insubstantial when compared to gross receipts from the motto games. For the two years under consideration, the percentage of gross motto receipts that was distributed for charitable purposes was 0.2% and 0.5%. The court held that the organization did not qualify for exemption under IRC section 501(c)(3) because it did not operate any charitable institutions and its principal activity was the profitable operation of motto games on a business or commercial basis.

### Rent

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#### State Law – Rent

Cal. Penal Code section 326.5(k)(2) limits the amount for rental of property and overhead to \$ per month. The law does not apply to cities that adopt their own ordinances. (Cal. Penal Code section 326.5(a).) Oakland adopted the provisions of the state Penal Code for it's ordinance, thereby adopting the \$ per month restriction.

#### State Penal Code Section 326.5

a) Neither the prohibition on gambling in this chapter nor in Chapter 10 (commencing with Section 330) applies to any motto game that is conducted in a city, county, or city and county pursuant to an ordinance enacted under Section 19 of Article IV of the State Constitution, if the ordinance allows games to be conducted only in accordance with this section and only by organizations exempted from the payment of the bank and corporation tax by Sections 23701a, 23701b, 23701d, 23701e, 23701f, 23701g, 23701k, 23701w, and 23701l of the Revenue and Taxation Code and by mobile home park associations, senior citizens organizations, and school districts; and if the receipts of those games are used only for charitable purposes.

(k) With respect to other organizations authorized to conduct motto games pursuant to this section, all proceeds derived from a motto game shall be kept in a special fund or account and shall not be commingled with any other fund or account. Proceeds are the receipts of motto games conducted by organizations not within subdivision (j). Those proceeds shall be used only for charitable purposes, except as follows:

(1) The proceeds may be used for prizes.

(2) (A) Except as provided in subparagraph (B), a portion of the proceeds, not to exceed 20 percent of the proceeds before the deduction for prizes, or two thousand dollars (\$) per month, whichever is less, may be used for the rental of property and for overhead, including the purchase of motto equipment, administrative expenses, security equipment, and security personnel.

#### **FINAL-REG, TAX-REGS, §1.513-5. Certain motto games not unrelated trade or business**

#### **§1.513-5. Certain motto games not unrelated trade or business**

(a) In general. —Under section 513(f), and subject to the limitations in paragraph (c) of this section, in the case of an organization subject to the tax imposed by section 511, the term “unrelated trade or business” does not include any trade or



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business that consists of conducting motto games (as defined in paragraph (d) of this section).

(b) Exception. —The provisions of this section shall not apply with respect to any motto game otherwise excluded from the term “unrelated trade or business” by reason of section 513(a)(1) and §1.513-1(e)(1) (relating to trades or businesses in which substantially all the work is performed without compensation).

(c) Limitations

(1) Motto games must be legal. —Paragraph (a) of this section shall not apply with respect to any motto game conducted in violation of State or local law.

(2) No commercial competition. —Paragraph (a) of this section shall not apply with respect to any motto game conducted in a jurisdiction in which motto games are ordinarily carried out on a commercial basis. Motto games are “ordinarily carried out on a commercial basis” within a jurisdiction if they are regularly carried out (within the meaning of §1.513-1(c)) by for-profit organizations in any part of that jurisdiction. Normally, the entire State will constitute the appropriate jurisdiction for determining whether motto games are ordinarily carried out on a commercial basis. However, if State law permits local jurisdictions to determine whether motto games may be conducted by for-profit organizations, or if State law limits or confines the conduct of motto games by for-profit organizations to specific local jurisdictions, then the local jurisdiction will constitute the appropriate jurisdiction for determining whether motto games are ordinarily carried out on a commercial basis.

(3) Examples. —The application of this paragraph is illustrated by the examples that follow. In each example, it is assumed that the motto games referred to are operated by individuals who are compensated for their services. Accordingly, none of the motto games would be excluded from the term “unrelated trade or business” under section 513(a)(1).

Example (1). Church Z, a tax-exempt organization, conducts weekly motto games in State O. State and local laws in State O expressly provide that motto games may be conducted by tax-exempt organizations. Motto games are not conducted in State O by any for-profit businesses. Since Z's motto games are not conducted in violation of State or local law and are not the type of activity ordinarily carried out on a commercial basis in State O, Z's motto games do not constitute unrelated trade or business.

Example (2). Rescue Squad X, a tax-exempt organization, conducts weekly motto games in State M. State M has a statutory provision that prohibits all forms of gambling including motto games. However, that law generally is not enforced by State officials

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against local charitable organizations such as X that conduct motto games to raise funds. Since motto games are illegal under State law, X's motto games constitute unrelated trade or business regardless of the degree to which the State law is enforced.

### **Compensated Workers – Security Guards**

In *South Community Ass'n v. C.I.R.*, U.S. Tax Ct., 20XX. United States Tax Court. It was found that paid security guards were considered compensated workers, the fact that the security guards who worked in the gaming operation were independent contractors, rather than employees was irrelevant and security guards were part of the workforce of gaming operations.

The role of the security guards as we see it was to prevent a robbery from being attempted in the first place, primarily by virtue of their physical presence at the sites of the motto games and the instant pull-tab ticket sales. We consider the security guards to be part of the workforce of the gaming operation, cf. *Waco Lodge No. 166, Benevolent & Protective Order of Elks v. Commissioner*, 696 F.2d 372 (5th Cir.1983) (concluding that a bartender's services on motto night were connected with the carrying on of the motto games although the bar was down the hall from the games), affg. T.C. Memo.1981-546, and conclude that the security guards worked in the gaming operation for purposes of the "substantially all" test.

### **Taxpayer's Position:**

The organization states that in the early years it could not give more money to charity because the high rents made it unprofitable. The organization claims that they are currently giving larger sums to charity.

### **Government's Position:**

Based on the facts of the examination ORG does not qualify for tax-exempt status under IRC 501(c)(3) because the organization does not engage primarily in activities that serve an exempt purpose. Even though ORG's articles of incorporation state that its specific purpose is to help children with their growth and development and support educational opportunities for the children and young adults in the United States of America. The organization primarily exists to hold weekly motto sessions and virtually no charitable donations are made by the organization. Conducting motto games while making no significant charitable donations or substantially serving an exempt purpose suggests that more than an insubstantial part of an organization's activities is not in furtherance of exempt purposes. An organization will not be regarded as exempt if more than an insubstantial part of its activities is not in furtherance of exempt purposes. See Treas. Reg. 1.501(c)(3)-1(c)(1).

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In order to be exempt under IRC 501(c)(3), an organization must be organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, educational purposes, etc. An organization that conducts motto games may be exempt under IRC 501(c)(3) if it uses the proceeds from motto to conduct a charitable program, commensurate in scope with its financial resources, of making grants to other charitable organizations. See Rev. Rul. 64-182, 1964-1 C.B. 186. In 20XX ORG's gross receipts totaled \$, of which\$ (or 0. %) was donated to charity. In 20XX gross receipts were \$ out of this \$ ( or .0%) was donated to charity. In 20XX gross receipts were \$ out of this \$ (or 0.%) was donated to charity. This minimal amount of donations does not represent a charitable program commensurate in scope with its financial resources as stated in Rev. Rul. 64-182, 1964-1 C.B. 186. In *Help the Children, Inc. vs. Commissioner*, 28 T.C. 1128 (1957), an organization's charitable function consisted of contributions to charitable institutions of amounts that were insubstantial when compared to gross receipts from the motto games. In this case contributions were .2 and .5%. The court held that the organization did not qualify for exemption under IRC 501(c)(3) because it did not operate any charitable institutions and its principal activity was the profitable operation of motto games on a business or commercial basis.

Year	Gross Receipts	Donated to Charity	Percentage
20XX			
20XX			
20XX			

ORG rents a building from CO-1 20XX. Facility rents paid were as follows, In 20XX - \$ or \$ per month. In 20XX - \$ or \$ per month ( there were two locations in 20XX, Address \$ & Address \$). In 20XX the org paid \$ or \$ per month. Equipment rental ( these amounts were paid to CO-2 a company controlled by BM-1) was \$ (or \$ per month) in 20XX and \$ (or \$ per month) in 20XX (amounts for the 20XX year are not available) It should be noted that during this time period State state law limited rent and overhead to \$ per month.

Section 1.501(c)(3)-(d)(1)(ii) of the regulations states that an organization must be organized to serve a public rather than a private interest. The service believes that such large payments to entities controlled by the same individual for weekly facility and equipment rentals are in violation of Regulation 1.501(c)(3)-(d)(1)(ii). These payments show a private benefit to the lessor, BM-1. Even if the State Regulations are not enforced, per Reg 1.513-5 violation of the state law still make the organization's activities fall outside the UBI exception for motto.

The amounts paid for private security, over \$ per year constitute paid compensation which makes the motto activities not meet the motto exception to UBI per the code.

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**Conclusion:**

Due to the excessive amounts paid for rent as well as paying compensation to security guards, the organization's activities constitute unrelated trade or business activity

Conducting motto games while making no significant charitable donations or substantially serving an exempt purpose suggests that more than an insubstantial part of an organization's activities is not in furtherance of exempt purposes. An organization will not be regarded as exempt if more than an insubstantial part of its activities is not in furtherance of exempt purposes. See Treas. Reg. 1.501(c)(3)-1(c)(1).

Based on the foregoing reasons, the organization does not qualify for exemption under section 501(c)(3) and its tax exempt status should be revoked effective January 1, 20XX.